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No. 92-665

IN THE SUPREME COURT
OF THE
UNITED STATES

October Term, 1992

Dan O. Davis
Petitioner,

vs.

United States of America,
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

REPLY BRIEF FOR THE PETITIONER

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ARGUMENT

1. In order for liability to attach under section 6672, the two requirements set forth in the statute must be met: (1) one must be a responsible person and (2) one must "willfully" fail to meet the statutory obligations - to withhold, truthfully account for and pay over the withheld taxes. Davis does not contest that he was a responsible person. However, he contends that his conduct does not violate the statutory duties, as construed by this Court

in *Slodov v. United States*, 436 U.S. 238, 78-1 USTC ¶9447 (1978).

The only fact which distinguishes Davis from the taxpayer in *Slodov* is that Davis was a responsible officer while the taxes were accruing, whereas Slodov was not. This fact is not germane to the pronouncements in *Slodov* that section 6672 does not impose liability without fault, and that section 7501 does not impose a trust on after acquired funds.

The consequence of the result in this case, if upheld, is that one who is technically a responsible person, but who has no actual knowledge that taxes are not being paid on time, and perforce has played no part in their non-payment, will have an *absolute duty* to pay all funds coming to the corporation after he learns of the unpaid taxes to payment of those taxes. Failure to do so will subject such a person to various consequences, including potential criminal liability, see *Slodov*, 436 U.S. at 253, 259, 26 U.S.C. §§ 7201, 7202, and certain personal liability for all unpaid withholding taxes under § 6672.

Davis recognizes that every Circuit Court that has addressed this question has ruled in favor of the United States, and that this Court has denied certiorari in two of such cases. *Honey v. United States*, 963 F.2d 1083, 1087-1089 (8th Cir. 1992), cert. denied, No. 92-460 (Dec. 7, 1992); *Thibodeau v. United States*, 828 F.2d 1499, 1505-1506 (11th Cir. 1987); *Vespe v. United States*, 868 F.2d 1328, 1335 (3d Cir. 1989); *Garsky v. United States*, 600 F.2d 86, 90-91 (7th Cir. 1979); *Kizzier v. United States*, 598 F.2d 1128, 1133-1134 (8th Cir. 1979); *Mazo v. United States*, 591 F.2d 1151, 1157 (5th Cir. 1976), cert. denied, sub nom, *Lattimore v. United States*, 444 U.S. 842 (1979), and the Ninth Circuit in this case.

This unanimous alignment notwithstanding, Congress could not possibly have intended to force persons in this circumstance to choose among attempting to rehabilitate the corporation and subjecting themselves to these Draconian consequences,

resigning their positions[1] or relegating the corporation to bankruptcy.[2]

The Ninth Circuit opined that existing management may be under certain limitations on its abilities to "walk away upon learning of an overdue tax liability." (Pet. App. 14a). No authority is cited for this proposition. Businesses fail and close their doors every day. Management may be subjected to some liabilities, but those liabilities are very different from that imposed under § 6672; most significantly, claims must be brought by an aggrieved party, who must then prove its case, and any liabilities are most likely dischargeable in a personal bankruptcy. Given these choices most well advised, hard-nosed business persons would choose to close the business and risk the potential claims that may be made, as opposed to the certain 100% penalty liability if the rehabilitation fails. This rationale wholly ignores the safety net of bankruptcy protection. If the business is worth saving, the well advised manager will have no choice but to file a bankruptcy case.

The Ninth Circuit's logic that "leaving is no guarantee that liability will not still attach [because] [a] judge or jury could disbelieve protestations of ignorance or find that the officer acted recklessly or was willfully ignorant of the failure to pay taxes," (*Id.*) also misses the mark, because under those circumstances all the facts which establish liability under § 6672

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[1]Davis recognizes that reckless disregard is a substitute for willfulness. There was no such finding in this case, and although the United States contends that the jury's verdict could have rested on such a determination (Br. Opp. at 6, note 1), the facts in this case make it clear that such was not the case. (See Pet. C.A. Rep. Br. at 6-13). However, under the government's theory recklessness is irrelevant, because the mere act of committing funds to other creditors after learning of the unpaid taxes constitutes willfulness; no resort to a reckless disregard analysis is needed. Moreover, if a person has acted with reckless disregard, resignation will not avoid the penalty.

[2]An immediate filing under chapter 7 or 11, 11 U.S.C., will insulate a person from 100% penalty liability, because after filing no funds may be expended for pre-petition debts without bankruptcy court approval.

have already occurred; nothing can be done to avoid liability. That is not a reason to hold liable one who was not reckless and who really did not know of the taxes.

The concern that "corporate roulette" may facilitate evasion also misses the mark. Resignation does not relieve from liability a responsible person who is otherwise liable for the 100% penalty.[3] Rather, the question is whether those who are not otherwise liable, e.g., because without knowledge of the unpaid taxes they have not acted willfully, subject themselves to liability by undertaking to rescue the financially troubled corporation.[4] We agree that "Congress did not intend to leave the collection of withholding tax payments to an evasive scheme of official 'corporate roulette.' (Pet. App. 14a)." (Br. Opp. at 9). However, Congress did not intend to hammer those who did not participate in the corporate derelictions with heavy civil and criminal penalties merely because they try to correct the situation by rehabilitating the corporation, and even facilitating substantial payments to the IRS which it would not otherwise receive, as in this case. In this respect this case is indistinguishable from *Slodov*. No taxes are evaded and no person is relieved from liability. Rather, the net of liability is drawn around another person, whose only "fault" is attempting to save the corporation from extinction. The rule of this case merely affords the government another pocket into which to reach for payment.

Moreover, Congress could not have intended to force upon managers, who belatedly learn of unpaid taxes, a requirement

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[3]The real problem faced by the government in this case is that the persons who were responsible for ITAC's failure to pay its employment taxes have both died. This circumstance simply does not justify extension of penalty liability to one who did not violate any duty addressed by § 6672.

[4]The officer should have an opportunity to have the jury decide this question. Under the government's theory of this case, however, the question is never put to the jury, because subsequent payment of other creditors renders the officer *absolutely liable*.

which virtually guarantees that the corporation will fail. Imposition of an absolute duty to commit all funds henceforth acquired by the corporation to payment of the accrued taxes mandates that there will not be any funds remaining with which to operate. Wages, suppliers, rent and every other operating expense cannot be paid without violating this duty. Recovery and survival are impossible for a corporation with no funds available for operations. Thus, satisfying the obligation which the Ninth Circuit has said is imposed by § 6672 will invariably result in failure of the corporate employer. The fisc does not require such a result, and a magnanimous sovereign would not demand it. See *World Marketing, Ltd v. Hallam*, 608 F.2d 392, 395 (9th Cir. 1979).

The purpose of the statute is to facilitate collection of taxes, not to force failure on troubled corporations. This purpose will be frustrated, not furthered, by imposition of absolute liability on managers whose attempts to rehabilitate financially troubled corporations do not succeed. Any manager who is aware that he must choose between satisfying the obligation to pay all funds available to the government and watching the corporation die, or continuing operations at his own peril, including possible criminal prosecution, will have no practical alternative other than immediately to cease operations or file for bankruptcy protection.[5] The purpose of the statute will be advanced by encouraging knowledgeable managers to try to rehabilitate the distressed corporation. As in this case, it is likely that the IRS will receive payments on the delinquent taxes during the attempted rehabilitation. If successful the statutory purpose will be fulfilled, as the taxes will be paid. If unsuccessful, the 100% penalty may still be assessed against those who were at fault for the unpaid taxes. However, the person who was not willful

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[5]One other possibility does exist, and that would be to arrange a quick sale to an outside, third party. This new owner would, of course, have no personal liability if the taxes are not paid. *Slodov*, supra. But why should the business owner have to resort to this form over substance technique, when he is the most knowledgeable person with the best chance to rescue the business?

before the attempt to salvage the business must not be turned into a "willful" actor by the adoption of the government's theory.

2. The government and the court of appeals in this case have misconstrued Davis' contention that the fourth quarter of 1981 assessment should be reduced, by treating it as a request to reallocate payments. Rather, Davis agrees that the IRS properly allocated ITAC's undesignated payments as it chose. See *Muntwyler v. United States*, 703 F.2d 1030, 1032 (7th Cir. 1983). The point of disagreement is the effect of such an allocation on the assessment to which it has been applied. Davis contends that the effect is *extinguishment* of the assessment, pro tanto. (Pet. 20-24). While the IRS may be free to reallocate such payments, the assessment so paid remains extinguished unless and until the IRS makes a new assessment. Indisputably, this was not done. (CR 14, Exhibit B-2, Certificate of Assessments and Payments).

Moreover, there is a split between the circuits on the question whether partial payment extinguishes an assessment pro tanto. The Ninth Circuit, in this case, has ruled it does not (Pet. at 25a, note 4);[6] the Fifth Circuit has ruled that it does. *United States v. Wilkes*, 946 F.2d 1143, 1150-1152 (5th Cir. 1991). In *Wilkes*, an estate paid $16,025.47 against an assessment of $16,243.58. The IRS made a posting error, and refunded this payment to the taxpayer. Subsequently the IRS brought suit to

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[6]However, this decision appears inconsistent with that court's prior decision in *Brookhurst, Inc. v. United States*, 931 F.2d 554 (9th Cir.), cert. denied 112 S. Ct. 299 (1991). In this regard the government errs in stating (Br. Opp. at 10) that *Brookhurst* does not address the effect of reallocation of a tax payment. The reason the IRS could not reassess the liability in that case was precisely because it had been extinguished by the prior payments, and the erroneous refund did not revive the assessment. At the time the IRS discovered its mistake, it was too late to make a new assessment. The significance of *Brookhurst* is the principal that payment extinguishes an assessment. The payment having been extinguished, the IRS was required to make a new assessment in order either to collect it from ITAC or assess a 100% penalty with respect thereto against Davis.

reduce an unpaid assessment to judgement. The Fifth Circuit held that the taxpayer's partial payment extinguished the assessment to the extent of the payment, and that the only avenues available to the IRS were to file timely suit for erroneous refund or to make a new assessment for the amount refunded. Because the IRS could not at that time have done either, judgement was rendered in favor of the IRS in the amount of $218.11, the *unpaid* balance of the assessment.

The government also errs in contending (Br. Opp. at 10, note 3) that the District Court decided the question whether any reallocation was in fact made adversely to Davis. The government avers that this alleged determination was not clearly erroneous, relying on Form 4183, 100-Percent Penalty Data (CR 25, Exhibit 1 at 4).

First, the District Court made no factual determinations in its Order (CR 26), which recited only that good cause had not been shown.

Second, any such factual determination is clearly erroneous. The government's Certificate of Assessments and Payments ((CR 14, Exhibit B-2) is a certified record, and is presumptively correct. The government contended below (Br. C.A. at 28, note 8) that the "Form 4183 demonstrates that notations regarding the reallocation were inadvertently omitted." This contention was raised for the first time on appeal, and it is significant that the Ninth Circuit made no references to the question whether any reallocation was actually made. Furthermore, no evidence was produced by the government to support the contention that any data was omitted from the Certificate of Assessments and Payments. If the government intended to impeach its certified record, it should have notified Davis of its intention, which it did not, and it should have produced evidence to support its contention, which it also failed to do. In these circumstances any determination that the IRS made reallocations, not reflected on its Certificate of Assessments and Payments, is clearly erroneous.

CONCLUSION

This Court has recognized that § 6672 does not impose liability without personal fault. *Slodov*, 436 U.S. at 254. Davis was not personally responsible for ITAC's failure to withhold taxes; he was not even aware of any such failure. Neither was he aware, until after the fact, that ITAC had not met its obligation to remit the withheld taxes to the government. All Davis did, after he learned of the unpaid taxes, was to continue operations and facilitate ITAC's payment of $35,000 to the IRS. ITAC failed. The withheld funds having been dissipated beforehand, ITAC's after-acquired funds were not impressed with a § 7501 trust. *Slodov*, 436 U.S. at 256-259. Davis is being held personally liable notwithstanding his lack of personal fault, in violation of the principals enunciated by this Court in *Slodov*.

Furthermore, imposing an absolute requirement, to pay all funds acquired by the corporation to the IRS, on managers who learn after the fact that their corporation has not paid its taxes contravenes the purpose of the penalty statute. Rather than enhance tax collections, it will guarantee closure or bankruptcy of troubled corporations.

The petition for writ of certiorari should be granted so this Court can settle the conflict between the applicable statute as interpreted by this Court in *Slodov* and the several Courts of Appeals cases involving managers who belatedly learn of unpaid taxes. *Davis v. United States*, 961 F.2d 867 (9th Cir. 1992); *Honey v. United States*, 963 F.2d 1083; *Thibodeau v. United States*, 828 F.2d 1499; *Vespe v. United States*, 868 F.2d 1328; *Garsky v. United States*, 600 F.2d 86; *Kizzier v. United States*, 598 F.2d 1128; *Mazo v. United States*, 591 F.2d 1151. Managers of financially troubled corporations must be guided so they may make an informed choice.

The writ of certiorari should also be granted in order to resolve the conflict between the Ninth Circuit in this case and the Fifth Circuit in *Wilkes*, 946 F.2d 1143, concerning the effect of

payment on tax assessments, and because a clear mistake has been made in assessing Davis for taxes which were paid by ITAC.

Respectfully Submitted,

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December 30, 1992